

## **WHAT IS THE CREDIT CHANNEL OF MONETARY POLICY TRANSMISSION?**

Monetary policy works in part by altering credit flows. The use of legal reserve requirements provide monetary authorities with considerable leverage over the quantity of funds that banks may maintain, just as open market sales reduces the real quantity of deposits banks can issue. This in turn induces banks to contract or expand lending which ultimately constrain or increase the spending capacity of borrowers. In addition to affecting short term interest rates, monetary policy affects aggregate demand by affecting the availability or terms of new credit.

The credit channel of monetary policy generates direct impact on aggregate demand and output and this is supported by certain fundamental assumptions. The underlying premise is that bank loans are an important source of funds for business activity, and that there is no perfect substitute for this kind of credit such as certificates of deposit or commercial papers or other sources of funds. Second, the central bank in practical terms is in a position to constrain bank's ability to lend, and finally, there exists bank dependent businesses that are unable to substitute credit from other financing sources. If these conditions exit, it is assumed that banks cannot just reduce commercial papers in order to keep the supply of loans at the level prior to the tightening or expansion signals in monetary policy; and businesses are unable to offset at no extra costs a decline in loan supply by issuing more papers, or effecting any substitution.

Thus, the credit channel presupposes that banks play an important role in the financial system. The credit channel at a glance is presented below:

***Contractionary Monetary Policy***→Supply of Bank Loans (Reduce)→Investment (Reduce)→Employment (Reduce)→Output (Reduce)

***Expansionist Monetary Policy***→Supply of Bank Loans (Increase)→Investment (Increase)→ Employment (Increase)→Output (Increase)